

Message Text

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FM AMEMBASSY LONDON

TO TREASURY DEPT WASHDC IMMEDIATE

SECSTATE WASHDC 8424

C O N F I D E N T I A L SECTION 1 OF 2 LONDON 19579

LIMDIS

STATE PLEASE PASS FEDERAL RESERVE BOARD

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: H.M. TREASURY FORECASTER ON THE BRITISH ECONOMY

REF: FAUVER/AMMERMAN TELCON

SUMMARY: H.M. TREASURY SENIOR FORECASTER HAS SUPPLIED FINANCIAL ATTACHE WITH HIS OWN BEST ESTIMATES OF WHAT IS LIKELY TO HAPPEN IN 1976-78. FORECAST IS BASED ON COMPUTER FORECAST THAT BEGAN TO YIELD RESULTS END OF OCTOBER, MASSAGED BY JUDGMENTAL FACTORS. OUTLOOK IS FOR MODEST BUT INCREASING GROWTH. SOME DECLINE IN INFLATION IN 1978 AND STEADY TENDENCY TOWARDS BALANCE OF PAYMENTS SURPLUS. END SUMMARY

1. SENIOR ECONOMETRIC FORECASTER IN H.M. TREASURY HAS SUPPLIED FINANCIAL ATTACHE WITH FOLLOWING ESTIMATES WHICH SOURCE STRESSED ARE HIS OWN. THEY REPRESENT THE VIEW OF A HIGHLY KNOWLEDGEABLE INSIDER BUT SHOULD NOT BE TAKEN AS AN OFFICIAL H.M. TREASURY FORECAST. THE FORECAST WOULD HAVE TO BE CHANGED AS A RESULT OF THE PROGRAM OF CUTS TO MEET IMF CONDITIONALITY.

ANNUAL GROWTH, YEAR OVER YEAR

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1976 1977 1978

(ALL FIGURES BELOW : PERCENT)

GDP 1 1/2 2 1/2 3
MFG PRODUCTION 3 7 5
RETAIL PRICES 16 1/2 15 9 1/2
WAGES PRESENT POLICY FOLLOWED, ASSUME 10 PERCENT
EARNINGS INCREASE IN 1977/78 INCOMES ROUND
CONSUMPTION
PUBLIC 2.5 TO 3 0 SLIGHT INCREASE
PRIVATE 0 -0.5 TO -1.0 0.5
REAL PERSONAL DISP. INCOME
-0.5 -3 1
TOTAL GOV'T EXPENDITURE (INVEST. & CONSUMTION)
N/A -1 -1
INVESTMENT
GOVERNMENT 0 -6 -5
MANUFACTURING
-8 1/2 16 16
EXPORT VOLUME (MANUFACTURING)
(1970 PRICES) 8 9 6
IMPORTS (TOAL/GOODS) (1970 PRICES)
8 5 3
WORLD TRADE EXPORT VOLUME
10 10 8
(ABOVE FIGURES IN PERCENT)
(FIGURES BELOW IN BILKIONS OF POUNDS)
CURRENT ACCCOUNT
-1.75 TO -2 -1 TO -2 0 TO 2
INVISIBLES 1.5 1.5 TO 1.7 2.75 TO 3.0
PSBR 11.25 TO 11.50 10.5 TO 11.0 9 TO 11
UNEMPLOYMENT - DECEMBER (MILLIONS S.A)
1.5 1.5 TO 1.7 1.5 TO 1.7

2. SOURCE GAVE SOME FURTHER ELABORATION ON THE ABOVE ESTIMATES. GROWTH IN MANUFACTURING PRODUCTION IN 1977 WOULD COME FROM EXPORTS AND INVENTORY BUILDUP.

3. INCOMES POLICY IN 1977 AND 1978 IS ASSUMED TO BE A 10 PERCENT INCREASE IN TOTAL EARNINGS PER ANNUM, INCLUDING SLIPPAGE.

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4. EXCHANGE RATE TRENDS ASSUME CONSISTENT COMPETITIVENESS (WHICH IS IMPORTANT FOR THE OUTCOME ON RETAIL PRICES, ALTHOUGH RATHER LESS IMPACT ON RETAIL PRICES IS SEEN THROUGH A FALLING POUND BECAUSE OF REDUCED DEMAND FOR IMPORTS AS A RESULT OF IMPORT SUBSTITUTION.

5. MANUFACTURING INVESTMENT IS EXPECTED TO INCREASE CONSIDERABLY FASTER THAN TOTAL PRIVATE INVESTMENT, WHICH WILL

SEE A DECLINE IN HOUSING INVESTMENT. THE TOTAL PRIVATE INVESTMENT ELEMENT WHICH INCLUDES HOUSING AND NORTH SEA OIL WILL LIKELY SHOW A DELCINE OF 4 PERCENT IN 1976, WHILE TOTAL PRIVATE INVESMENT INCREASES 1 PERCENT IN 1977 AND 4 PERCENT IN 1978. MANUFACTURING INVESTMENT SHOULD DO WELL DESPITE THE INCREASE IN INTEREST RATES. INVESTMENT IN DISTRIBUTION AND SERVICES IN EXPECTED TO TURN UP MORE SHARPLY TOWARDS THE END OF THE PERIOD.

6. A SHARP FALL IN REAL PERONAL DISPOSABLE INCOME IS EXPECTED WITHIN THE NEXT 12 MONTHS, THE MAIN QUESTION BEING HOW MUCH OF THE FALL WILL BE ABSORBED FROM A DECREASE IN THE SAVINGS RATE. THE FALL IN REAL TAKE HOME PAY WILL BE LARGER THAN THE FALL IN PERSONAL DISPOSABLE INCOME BECASUE OF CURRENT GRANTS AND TRANSFERS.

7. PUBLIC AUTHORITY, INCLUDING ESPECIALLY LOCAL AUTHORITY, INVESTMENT IS EXPECTED TO FALL DURING THE PERIOD, WHILE WITHIN THE PUBLIC AUTHROITY COMPONENT, CENTRAL GOVERNMENT AND NATIONALIZED INDUSTRY INVESTMENT SHOULD BE FAIRLY FLAT.

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C O N F I D E N T I A L SECTION 2 OF 2 LONDON 19579

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8. THE IMPACT OF HIGH INTEREST RATES ON INVESTMENT. THERE ARE DIFFERING VIEWS HELD WITHIN H.M. TREASURY. ALL AGREE THAT HIGH INTEREST RATES INHIBIT INVESTMENT IN INVENTORIES AND WORKING CAPITAL. ONE GROUP CONSIDERS THAT

LOWER INTEREST RATES WOULD HAVE A SHARPLY BENEFICIAL EFFECT ON BUSINESS CONFIDENCE AND PROMOTE ACTIVITY THROUGH THE MULTIPLIER AND ACCELERATOR PRINCIPLE. OTHERS MAINTAIN THAT GIVEN TAX WRITE OFFS, LIBERAL DEPRECIATION AND INVESTMENT INCENTIVES IN DEVELOPING DOMESTIC AREAS, THE HIGH INTEREST RATES MAY CHANGE THE PROFILE OF INVESTMENT, CHECKING IT SOMEWHAT, BUT WILL NOT HAVE A NEGATIVE IMPACT OVER A LONGER PERIOD.

9. EXPORTS. FORECASTING THEM IS AGONY AND FORECASTING PERFORMANCE DURING PAST 3-4 MONTHS HAS BEEN DISTURBING. OVER AN ENV LONGER PERIOD THE FORECASTING RESULTS ARE DISAPPOINTING. SOURCE CONSIDERED THE IMPROVEMENT IN PRICE COMPETITIVENESS HAD BEEN SMALL AS A RESULT OF STERLING'S DECLINE, WHEREAS PROFIT IMPROVEMENT WAS BETTER. THIS IS REFLECTED IN TERMS OF TRADE. THE UK CONSIDERS ITS GROWTH OF EXPORT VOLUME WILL BE LESS THAN THE GROWTH OF WORLD TRADE, ROUGHLY 60 PERCENT OF THE GROWTH IN WORLD TRADE, CETERIS PARIBUS, ALTHOUGH THE FORECAST SHOWS BETTER RESULTS, DUE PERHAPS TO INCREASED UK COMPETITIVENESS.

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10. IMPORTS. THE MAIN DOUBT HERE IS ON THE DEGREE OF IMPORTED MANUFACTURING GOODS PENETRATION. HM TREASURY FORECASTERS SEE SIGNS OF IMPORT SUBSTITUTION, BETTER PRICE COMPETITIVENESS BUT THE TREND TOWARDS HIGHER INCOME ELASTICITY AND GREATER IMPORT PENETRATION GOES ON.

11. TERMS OF TRADE ARE CRUCIAL. SOURCE CONSIDERED HIMSELF PERHAPS ONE ON THE PESSIMISTIC END, NOT SEEING WORLD COMMODITY PRICES SLOW DOWN SIGNIFICANTLY UNTIL THE LAST HALF OF 1977.

12. THE INVISIBLES ACCOUNT. VERY SHARP GAINS ARE EXPECTED ON TOURIST ACCOUNT, ALTHOUGH THE INTEREST, PROFITS AND DIVIDEND (IPD) ACCOUNT WILL WORSEN. THE EFFECT OF A DEPRECIATION IS OF COURSE TO SHOW HIGHER STERLING RETURN; THIS MUST BE TAKEN INTO ACCOUNT. AS NORTH SEA OIL COMES ON LINE, CAPITAL ACCOUNT INFLOWS WILL BE LESS, WHEREAS INVISIBLES OUTFLOWS WILL GROW UNDER INTEREST, PRINCIPAL AND DIVIDEND PAYMENTS. OFFSETTING THIS WILL BE REDUCED SHIPPING DEBITS (AS A RESULT OF REDUCED OIL IMPORTS).

13. ANOTHER TREASURY FORECASTER (WHOSE PRIMARY RESPONSIBILITY IS BALANCE OF PAYMENTS) SEES THE CURRENT ACCOUNT MOVING INTO BALANCE TOWARD THE END OF 1977. HE EMPHASIZES AS WELL THE MARGIN OF ERROR THAT ATTENDS THESE FORECASTS,

NOTING THAT THE MODEL HAS UNDERPREDICTED IMPORTS BY 5 PERCENT AND OVERPREDICTED EXPORTS BY 8 PERCENT FOR THE 3RD QUARTER OF 1976, THE LAST QUARTER AVAILABLE. WITH THIS WARNING IN MIND, HE SEES THE UK'S CURRENT ACCOUNT MOVING INTO BALANCE TOWARD THE END OF 1977, AND INTO RESPECTIBLE SURPLUS IN 1978.

14. THE IMPROVEMENT IN 1978 OVER 1976 OF ROUGHLY 3 BILLION POUNDS IS ATTRIBUTABLE TO A FALL IN THE VALUE OF OIL IMPORTS OF SOME 1.5 BILLION POUNDS AND AN IMPROVEMENT OF 1.5 BILLION IN NET INVISIBLES. THE OIL SECTOR IS, IN FACT, RESPONSIBLE FOR THE PART OF THE IMPROVEMENT IN INVISIBLES AS IMPORTED SERVICES RELATED TO NORTH SEA OIL INSTALLATIONS DECLINE, AND AS THE MERCHANDISE

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FREIGHT AND INSURANCE COSTS OF IMPORTING OIL DECLINE. IN ADDITION THE DECLINE IN STERLING IS EXPEDITED TO INCORPORATE SUBSTANTIALLY TOURIST RECEIPTS, AND THERE SHOULD BE A MODEST INCREASE IN FINANCIAL EARNINGS FROM THE CITY. THESE IMPROVEMENTS ARE SEEN TO BE SUFFICIENT TO OFFSET THE INCREASE FOREIGN EXCHANGE PAYMENTS ON THE EXTERNAL DEBT, WHOSE GROWTH WILL IN ANY CASE DECLINE AS THE CURRENT ACCOUNT DEFICIT NARROWS.

15. COMMENT: FORECAST IN PARAS 1-12 COMES FROM A PARTICULAR CONSERVATIVE ECONOMIST. NOTE, FOR EXAMPLE, HIGHER LEVEL OF PSBR AND HIGHER LEVEL OF BALANCE OF PAYMENT DEFICIT (OR LOWER SURPLUS) THAN SOME OTHERS, INCLUDING H.M. TREASURY, ARE PREDICTING. FINANCIAL ATTACHE CONSIDERS THAT SOURCE GAVE WHAT HE CONSIDERED MOST LIKELY OR LEAST FAVORABLE OUTCOME ON JUDGMENTAL BASIS, DESPITE PERHAPS ROSIER COMPUTER MODEL PRINTOUTS. DURING PERIOD OF UNCERTAINTY IN UK ECONOMIC INDICATORS AND TRENDS, WE CONSIDER ABOVE ESTIMATES PLAUSIBLE.

16. ALTHOUGH HM TREASURY PUBLISHED ITS MACROECONOMIC MODEL IN FEBRUARY 1976, MANY OF THE EQUATIONS USED HAVE BEEN CHANGED. WE DO NOT HAVE ALL THE ASSUMPTIONS WHICH HMTREASURY IS USING. FINANCIAL ATTACHE'S IMPRESSION IS THAT UK FORECASTERS HAVE NOT BEEN ABLE TO ASSESS TO THEIR OWN SATISFACTION THE UNDERLYING STRENGTHS AND WEAKNESSES OF UK ECONOMY, OTHER THAN NOTING THE DETERIORATION IN CURRENT STATISTICS IS WORSE THAN EXPECTED TWO MONTHS AGO. MAJOR UNKNOWN AND EXTREMELY IMPORTANT DETERMINATION OF 1977 AND 1978 PERFORMANCE WILL BE LEVEL OF PERSONAL SAVINGS (WILL IT DECLINE?) AND INCREASE IN MANUFACTURING INVESTMENT (HOW MUCH?). BOTH IN LARGE PART WILL BE DETERMINED BY AN INTANGIBLE, IE, CONFIDENCE.

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